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No. 99-1295

In The

Supreme Court of the United States

DAVID A. and LOUISE A. GITLITZ;
PHILIP D. and ELEANOR G. WINN,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Tenth Circuit

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QUESTION PRESENTED

Petitioners are shareholders in an insolvent Subchapter S corporation which obtained a discharge of indebtedness. Income with respect to this cancellation of debt ("COD") was excluded from gross income under 26 U.S.C. § 108(a). The question presented in this case is whether excluded COD income is an item of income within the meaning of 26 U.S.C. § 1366(a)(1)(A), which increases Petitioners' basis in their S corporation stock pursuant to 26 U.S.C. § 1367.

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I. ARGUMENT

Tacitly recognizing that the rationale and statutory interpretations he advanced in the lower courts are not supportable, the Commissioner now abandons those positions altogether. In their place, he resurrects the "no income" argument rejected by the Tax Court in its first opinion in this case. The Commissioner fails to confront the Tax Court's holding that the "no income" argument relies upon a judicially crafted rule that was expressly eliminated with the enactment of § 108.[1]

The Commissioner attempts to bolster his "no income" position with the argument that Congress intended that shareholder losses, in all circumstances, be eliminated by the amount of COD. This argument ignores the controlling statutory provisions of §§ 108(d)(7)(B) and 1366(d)(1), which require that COD be taken into account in determining the suspended loss attribute subject to reduction. While the Commissioner argues that the Taxpayers' position will defeat attribute reduction entirely, it only places S corporation shareholders on par with all other taxpayers who have attributes and who are entitled to the full use of such attributes in determining taxable income for the year of the discharge.

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[1] All statutory citations, unless otherwise specified, refer to Title 26 (the Internal Revenue Code of 1986). Citations to Regulations or Treasury Regulations refer to 26 C.F.R.

A. The exclusion of any item of income, including COD, from gross income does not mean the item is not "income."

The central theme of the Commissioner's entire brief is that the amount of discharged debt excluded under § 108 is not income. *See* CMB:18.[2] This argument is squarely refuted by the plain language of §§ 61 and 108. "Gross income" is defined in § 61 to mean *all* income, from whatever source derived, including some fifteen listed items. Discharge of debt is one of the items listed. § 61(a)(12). Section 61(a)(12) draws no distinction between a solvent or insolvent debtor.

The inclusion of an item in gross income under § 61 means that the item will be used, first, in the determination of adjusted gross income, and, ultimately, in the determination of taxable income and tax. *See* §§ 62, 63, 1, and 11. MERTENS, JACOB, THE LAW OF FEDERAL INCOME TAXATION, §§ 5:01, 5:06. This is so unless an income item otherwise included within the reach of § 61 is specifically excluded from gross income by §§ 101 through 138. MERTENS, at § 5:06.

Sections 101 through 138 each contain the operative language "gross income does not include," then describe the item excluded. These exclusions prevent the item from being included in the computation of "gross income" and "taxable income." For that reason,

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[2] The abbreviation "CMB:xx is used to refer to the "Commissioner's Merits Brief" in this case. Similarly, the abbreviation "TMB:xx" is used to refer to the "Taxpayers' Merits Brief."

§ 1366(a)(1)(A) requires that "all items of income (including tax-exempt income)" be taken into account by an S corporation shareholder. In its first opinion in this case, the Tax Court concluded:

> Respondent would have us treat differently the operation of § 61(a)(12) and 108 and, for example, §§ 61(a)(4) and 103 (relating to interest) or § 61(a)(10) and 101 (relating to insurance). Respondent argues that, as an illustration, death benefits are first realized under § 61(a)(10) and then certain death benefits are excluded, i.e., not recognized, by § 101. Respondent argues that no such realization occurs in the case of discharge of indebtedness.
>
> Section 61 requires that certain amounts be included in income, i.e., items of income. Specifically, § 61(a)(12) requires that income from discharge of indebtedness be included in gross income. Absent any exclusionary provision, items of income are included in gross income. Section 61(a). Sections 101 through 135 exclude specific items of income from gross income. Discharge of indebtedness income to the extent of insolvency is one of the items of income excluded. Section 108(a)(1)(A), (3).
>
> Based on the foregoing, we hold that discharge of indebtedness is an 'item of income' for purposes of determining a shareholder's basis in S corporation stock by its inclusion in the definition of gross income under § 61(a)(12).

Winn v. Commissioner, T.C.M. (RIA) 97,286, App. 30, *withdrawn and reissued on other grounds as* T.C.M (RIA) 98,071, *aff'd sub nom, Gitlitz v. Commissioner*, 182 F.3d 1143 (10th

Cir. 1999). The Commissioner never addresses the Tax Court's conclusion in this regard.

The Commissioner implies that the Tenth Circuit opinion in *Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999), concluded that income excluded under § 108 is not income. He states "The Court noted that a discharge of indebtedness does not constitute an item of income under § 108(a) if 'the debt is discharged in a bankruptcy proceeding or at a time when the debtor is insolvent . . . ' " CMB:6. Contrary to the Commissioner's selective quotation, the Tenth Circuit actually said that, under § 61(a)(12), the taxpayer whose debt is discharged generally has to recognize *taxable* income to the extent of the discharge. The *Gitlitz* court continued, "Section 108(a)(1) provides an exception to this rule, if, *inter alia*, the debt is discharged in a bankruptcy proceeding or at a time when the taxpayer is insolvent." *Gitlitz*, 182 F.3d at 1147. Thus, the Tenth Circuit concluded that the § 108 exclusion provides an exception to the rule that discharged debt is to be included *in taxable income*, not that § 108 eliminates debt discharge as an item of income. Indeed, the Court expressly held that excluded COD income *is* an item of income that "must pass through to shareholders unless [it is] absorbed by attribute reduction." *Gitlitz*, 182 F.3d at 1148.[3]

Every other court to examine the issue has agreed that COD income is an item of income under § 1366.

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[3] The Tax Court in *Nelson* likewise reasoned that "COD income" is excluded from the gross income of an S corporation at the corporate level. *Nelson v. Commissioner*, 110 T.C. 114, 121 (1998), *aff'd*, 182 F.3d 1152 (10th Cir. 1999).

United States v. Farley, 202 F.3d 198 (3d Cir. 2000); *Pugh v. Commissioner,* 213 F.3d 1324 (11th Cir. 2000); *Hogue v. United States,* 2000 WL 2651, 85 A.F.T.R.2d 2000-426 (D.Ore. 2000); *Gaudiano v. Commissioner,* 216 F.3d 524 (6th Cir. 2000); *Witzel v. Commissioner,* 200 F.3d 496 (7th Cir. 2000). *See* CMB:28 n.19.

B. Debt discharge results in realization of income, whether the debtor is solvent or insolvent. The pre-§ 108 judicial insolvency exception was expressly discarded with the enactment of § 108.

The Commissioner argues broadly that no income is *realized* as a result of an insolvent debtor's discharge from liability. For this sweeping proposition, he relies upon a 1923 Treasury Ruling, cases from the 1930s and 1940s, and a 1957 Treasury Regulation (§ 1.61-12(b)(1)). He argues that "In 1980 Congress embraced and codified this well established 'insolvency exception' by specifying in § 108(a) of the Code that the discharge of debt does 'not' constitute an item of 'income' to an insolvent taxpayer." CMB:13.

The statutory language of § 108(a) undermines the Commissioner's argument. It states, in part, "Gross income does not include any amount which (*but for this subsection*) would be included in gross income" by reason of discharge of indebtedness if the taxpayer is insolvent. § 108(a)(1)(B). (Emphasis supplied.) Section 108 only excludes items that are otherwise included in gross income. *See* SHEINFELD, MYRON M., FRED T. WITT, JR. & MILTON B. HYMAN, 15 COLLIER ON BANKRUPTCY TAXATION, ¶ 6.03[3][a][i], 6-77, 78 (Matthew Bender. 1999).

If, as the Commissioner argues, debt discharge of an insolvent debtor were not income, then it would not be excluded under § 108(a). Because the attribute reduction rules of § 108(b) apply *only* to amounts excluded by § 108(a), the discharge of indebtedness of an insolvent debtor would never result in attribute reduction – this is contrary to the statute and common sense.

Section 108(e)(1), moreover, provides that "Except as otherwise provided in [§ 108], there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness." In its initial decision, the Tax Court concluded:

> Section 1.61-12(b) restates the pre-Section 108 judicially created insolvency exception. Section 108 codified the insolvency exception as an exclusion from gross income. Section 108(e)(1) provides that 'There shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness', except as provided in § 108. Thus, § 108, not § 1.61-12(b) controls these cases. (internal citations eliminated)

Winn, T.C.M. (RIA) 97,286, App. 29. A well-respected treatise describes the relation between § 108 and prior law as follows:

> These rules, which were enacted in 1980, are exclusive and supercede earlier rules developed by the Courts and the IRS. § 108(e)(1). Under prior law, an insolvent or bankrupt taxpayer

> realized no income on a discharge of indebtedness and suffered no reduction in any tax attribute. . . . [4]

BITTKER, B. & LOKKEN, L., FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶6.46, at 6-58 n.97 (2d Ed. 1989). Thus, § 108 leaves no doubt that the pre-1980 cases, rulings, and Treasury Regulation upon which the Commissioner relies have no application with respect to income subject to § 108.[5]

The judicial insolvency exception should not play any part in this Court's consideration. As discussed extensively in *Newman v. Commissioner*, 934 F.2d 426 (2d Cir. 1991), the rule was based upon the notion that relief of debt should be taxed only if it results in a "freeing of assets" or "accession to wealth." Perhaps because of a depression-era reluctance to "kick someone when he is down," a rationale was formulated to avoid taxing a debtor who remained insolvent after debt relief. *Newman*, 934 F.2d at 431.

The judicial exception is not analytically supportable, particularly when it is recognized that cash income to an insolvent debtor remains taxable, even if the debtor used the cash to reduce the burden of debt, and even though

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[4] The Commissioner inexplicably cites this same section of Bittker & Lokken in support of his argument that the judicial insolvency exception remains good law. CMB:12.

[5] When it enacted § 108 in 1980, Congress specifically noted that "income from discharge of indebtedness should increase earnings and profits whether or not current tax is imposed on that income." S. Rep. No. 1035, 96th Cong., 2d Sess. 44 (1980), 1980 U.S.C.C.A.N. 7017, 7058. Thus, it is clear that Congress considered excluded COD as "income."

the debtor's assets are no more "freed up" than in the case of forgiveness of debt. *Newman*, 934 F.2d at 432. A debtor whose debt is discharged has in fact realized an economic benefit, even if he remains insolvent after the discharge, e.g., a debtor whose assets are $90,000 and whose debts are $200,000 certainly realizes an "accession to wealth" if $100,000 of his debts are discharged, despite remaining insolvent.

As the *Newman* court pointed out, citing to this Court's decision in *United States v. Centennial Savings Bank*, 499 U.S. 573, 581-582 (1991), borrowed funds are not considered income when obtained because the obligation to repay offsets the increase in assets. If the obligation to repay is extinguished, "the taxpayer enjoys a net increase in assets equal to the forgiven portion of the debt, and the basis for the original exclusion thus evaporates." *See also Tufts v. Commissioner*, 461 U.S. 300, 310 n.11 (1983); SHEINFELD, MYRON M., FRED T. WITT, JR. & MILTON B. HYMAN, 15 COLLIER ON BANKRUPTCY TAXATION, ¶ 6.02[2][a], 6-7 – 6-11 (Matthew Bender. 1999). The *Newman* Court concluded that the judicial insolvency rule was an "illogical exception" to the general rule, announced in *United States v. Kirby Lumber*, 284 U.S. 1 (1931), that debt relief is income. *Newman*, 934 F.2d at 432.[6]

The judicial insolvency exception amounted to the courts (with the acquiescence of Treasury) fashioning a de

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[6] As the taxable year at issue in *Newman* was prior to the effective date of § 108, the Commissioner "concede[d] to history" ("not without understandable complaint") and agreed that the rule applied. *Newman*, 934 F.2d at 432.

facto exclusion from gross income. However, only Congress can legitimately create exclusions. Congress rectified that situation and made the exception obsolete when it enacted the modern version of § 108.

In a further effort to support his "no income" argument, the Commissioner cites to the Senate Report relating to the enactment of § 108 (S. Rep. No. 1035, 96th Cong., 2d Sess. (1980) 2, 13) and a treatise (BITTKER, B. & LOKKEN, L., FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶7.6.3, 7-58 (3d Ed. 1999)), stating that any amount of debt discharged remaining after application against tax attributes is to be disregarded and "does not result in income or have other tax consequences."[7] CMB:15.

What the Commissioner fails to recognize is that attribute reduction takes place *after* the determination of tax for the taxable year of discharge. In the case of shareholder suspended losses, attribute reduction takes place *after* the passthrough of COD income has occurred and the loss in excess of basis has been determined under §§ 108(d)(7)(B), 1366(d)(1), and 1367(a). Once the current year's tax and the surviving tax attributes have been determined, the only remaining consequence of COD income is reduction in the attributes as of the beginning of the next taxable year. Thereafter, the item can indeed

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[7] By indicating the new attribute reduction rules were exclusive, the Senate acted to eliminate the various prior law modifications of tax status under the judicially created insolvency exception. For example, the Senate specifically intended to overturn the IRS policy of treating basis reductions in Investment Tax Credit property as dispositions, subject to recapture tax. S. Rep. No. 1035, 96th Cong., 2d Sess. 9 (1980), 1980 U.S.C.C.A.N. 7017, 7024.

be ignored.[8] Thus, the Senate Report, stating that income remaining *after* attribute reduction does not have further consequences, is consistent with Taxpayer's position: basis was adjusted *prior* to the time of attribute reduction.

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[8] The Commissioner also argues that the legislative history of the 1993 amendment to § 108 supports his position that there are no basis effects for excluded COD income, citing H.R. Rep. No. 111, 103d Cong., 1st Sess. 622 (1993). The amendment in question did not alter existing law as to the relationship between § 108 income and shareholder basis adjustments, but created a new elective exclusion of COD income for *solvent* taxpayers, conditioned upon a reduced basis in encumbered property. New § 108(a)(1)(D). The 1993 legislative history relates to the new § 108(a)(1)(D), and cannot be read to extend to other provisions of § 108. Moreover, a reduction in property basis may require a reduction in shareholder basis under § 1367(a)(2)(D). *See* § 1.1502-32(b)(3)(iii)(B) (treating § 1017 basis reductions as a "noncapital, nondeductible expense" under a consolidated return regulation that parallels § 1367(a)(2)(D)); *see also* § 50(c)(5). Even if it were read in the manner suggested by the Commissioner, the explanation by the 1993 Congress *11 years* after the Subchapter S Revision Act of 1982 (which enacted §§ 1366 and 1367 in their current form), provides no indication of legislative intent and understanding at the time that the controlling basis provisions of Subchapter S were enacted. *See Bufferd v. Commissioner*, 506 U.S. 523, 530 n.10 (1993). We note that this matter was addressed in "legislative history" shortly after the ABA Tax Section brought this matter to the attention of Treasury. Witt, Fred T., Jr., *Report of the [ABA] Section 108 Real Estate and Partnership Tax Force*, 46 Tax Law 209 (1992).

C. The Commissioner provides no principled reason for denying a basis increase for COD income, but permitting it for other items of non-taxable income.

Recognizing that all other items of income increase stock basis pursuant to §§ 1366 and 1367, the Commissioner struggles to offer a plausible rationale for denying COD income the same treatment.[9] The Commissioner

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[9] All items excluded from tax by statute should be accorded equal treatment under § 1366(a)(1)(A). Significantly, the Commissioner construed the phrase "including income exempt from tax" to include excluded COD income under § 108. Tech. Adv. Mem. 97-39-002 (construing § 705(a)(1)(B) – the partnership analogue of § 1366(a)(1)(A)). The Commissioner argues that for partnerships, this is a matter of no consequence because, simultaneous with the basis increase for partnership exempt income, there is an equivalent basis reduction under § 752. CMB:26 n.18. The Commissioner has not considered the implications of this argument. Essentially, he is arguing that partnerships should be treated better than S corporations. (In *Witzel*, Judge Posner noted that the Commissioner was seeking to impose a rule similar to § 752 on S corporation shareholders, but that he lacked a statutory basis for doing so. *Witzel*, 200 F.3d at 498.) Consider the case where an entity, S corporation or partnership, borrows money to fund a business venture, the venture fails, the entity and its owners are insolvent, and the lender forgives the debt. The partner was able to increase his basis by his pro rata share of the liability – the S corporation shareholder was not. When the losses were generated, the partner could deduct them up to the amount of basis – the S corporation shareholder did not have sufficient basis and her losses were suspended. When the partnership's liability was discharged, the insolvent partner's basis was increased by his share of the discharged liability under § 705(a)(1)(B), then decreased an equal amount under § 752, resulting in a zero basis. When the S corporation's liability was discharged, under

argues that, in contrast to a corporation's collection of life insurance proceeds or non-taxable bond interest, the insolvent corporation which is discharged from debt "acquires no asset for distribution in cash or in kind to its shareholders" and has "a reduction or extinguishment of liabilities without any increase in assets." CMB:23.

This argument relies upon an overly simplistic notion of "economic wealth" – it only takes into account increases to the asset side of the ledger and ignores decreases to liabilities. It assumes that cash proceeds representing exempt income will actually be collected by the corporation. In the case of zero coupon municipal bonds, this may not happen for years. Moreover, the cash collected may not be distributed to shareholders, but rather used to pay down debt, in which case the corporation is in exactly the same economic situation as if the debt itself were discharged. Accordingly, the bottom line

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the Commissioner's interpretation, the shareholder of the insolvent corporation is *not* able to increase her basis by her pro rata share of the discharge under §§ 1366 and 1367, and her losses are eliminated in attribute reduction. At the end of the day, while both have zero basis, the partner has obtained the benefit of business losses, but the S shareholder has not. The rule championed by the Taxpayers provides a rough equivalence of treatment between shareholders in insolvent S corporations and insolvent partners. Both obtain the benefit of the losses (the partner when the losses are incurred and the shareholder in the year of the discharge), and end up with a zero basis. Far from seeking benefits in excess of that accorded partners, the Taxpayers merely seek rough equivalence between the two types of passthrough entity.

balance sheet effect of debt discharge cannot be meaningfully distinguished from other types of non-taxable income. TMB:48-49.

Finally, the same rationale for increasing stock basis by the amount of non-taxable items of income applies with equal force in the case of COD income. TMB:48. If an increase to stock basis is not made to reflect the corporation's realization of COD income, then, if there is a distribution to the shareholders in the future, the amount of the debt discharge and the corresponding increase in net equity will be subject to tax, just as the amount of non-taxable bond interest would be subject to tax if no upward adjustment to basis were made. The Commissioner responds to this argument by retreating to the judicial insolvency rationale:

> [T]he treatment sought by Petitioners for debt discharge of an insolvent taxpayer would create an addition to basis (and thereby permit additional deductions) for which no offsetting item of 'income' exists.

CMB:24 n.17. The answer to this argument is that an offsetting item of income does exist, as Congress has expressly recognized in §§ 61 and 108.

D. The Commissioner disregards the language of the Treasury Regulation governing S corporation shareholders' adjustments to basis.

The Treasury Regulation governing adjustment to shareholder basis (Treas. Reg. § 1.1367-1(d)(2)) broadly requires an adjustment to basis for any "non-taxable item" where the item would have been included in

income for the taxable year under the corporation's method of accounting, had it been taxable. TMB:18-19. If the COD income of an insolvent debtor were not excluded from gross income by § 108(a), then it would have been taxable under § 61(a)(12) for the year of the discharge. This regulation leaves no doubt that excluded COD income must be taken into account in the Taxpayers' basis computations.

Even though this regulation applies directly to the issue of what items increase shareholder basis, the Commissioner claims that the 1957 Treasury Regulation under § 61, § 1.61-12(b)(1), is the controlling authority. CMB:24-25. As discussed above, this regulation restates an outdated judicial rule and is "plainly inconsistent with the statute" as amended in 1980, and should not be followed. *Rowan Cos. v. United States,* 452 U.S. 247 (1981); *United States v. Cartwright,* 411 U.S. 546, 557 (1973).

E. The Commissioner has abandoned the rationale adopted by the Tenth Circuit in this case. His argument that § 108(d)(7) precludes excluded COD income from being passed through to shareholders ignores § 108(d)(7)(B).

While the timing rule of § 108(b)(4)(A) was the linchpin of the Tenth Circuit's opinion (*Gitlitz,* 182 F.3d at 1149), the Commissioner now concedes that § 108(b)(4)(A) "has no bearing on the proper disposition of this case," and agrees that § 108(b)(4)(A) defers attribute reduction until "after the end of the tax period." CMB:36-37. The Commissioner argues instead that § 108(b)(4)(A) applies at the corporate level, and not at the shareholder level. But § 108(b)(4)(A) applies to *all* tax

attributes affected under § 108(b); it makes no distinction between shareholders' suspended losses (treated as corporate NOLs for attribute reduction purposes) and other attributes.

The Commissioner argues that §§ 108(d)(7)(A) and (B) reflect an "obvious intent" that the amount of discharged debt is to be applied to reduce or eliminate the shareholders' suspended losses. Thus, he argues, such losses should *not* pass through to the shareholders to enable them to deduct those same losses. CMB:27-31. The Commissioner never confronts the critical language of § 108(d)(7)(B). The Commissioner claims that § 108(d)(7)(B) provides that "any loss" "for the taxable year of the discharge" is treated as an attribute subject to reduction. The detailed statutory language of § 108(d)(7)(B), however, provides that only the shareholders' "loss disallowed for the taxable year of the discharge under § 1366(d)(1)" is treated as a corporate NOL for attribute reduction purposes.

This language means that *before* any shareholder loss can be treated as an NOL, there must be a determination as to the amount of the loss in excess of basis. § 1366(d)(1); TMB:33. In computing loss in excess of basis, § 1366(d)(1) requires that *all* items of income and loss for the current year, including those items of income for which a basis adjustment is required under § 1367(a), and those items of loss arising in a prior year and suspended under § 1366(d)(1), be taken into account. Any loss in excess of basis is carried forward to the next succeeding taxable year. § 1366(d)(2). It is only this "excess" that is subject to attribute reduction in place of an NOL. § 108(d)(7)(B).

As applied to the facts of this case, the rules of §§ 108(d)(7)(B), 1366(d)(1), 1366(a)(1)(A), and 1367(a) produce the following result: (1) the Taxpayers' suspended losses existing as of the end of 1990 are carried forward and treated as deductions in 1991; (2) a pro rata share of the S corporation loss for the 1991 year is taken into account by the Taxpayers; (3) a pro rata share of all items of S corporation income for the 1991 year is taken into account by the Taxpayers, including the excluded COD income, in order to determine stock basis for 1991; (4) the total loss is compared to adjusted stock basis, and to the extent that there is an excess, such excess is the amount disallowed under § 1366(d)(1) for the year; and (5) this disallowed amount is reduced by the amount of COD income in the attribute reduction process as of the beginning of the next succeeding taxable year. §§ 108(b)(2) and (b)(4)(A).

The Taxpayers' interpretation of §§ 108(b)(2) and 108(d)(7)(B) does not, as the Commissioner argues (CMB:29-30), eliminate the "price" Congress intended to impose upon the exclusion of COD from gross income under § 108. Congress specifically limited the price when it provided for attribute reduction only *after* determination of the tax liability for the year of discharge. This means that a debtor with an asset having a basis of $100,000 and a fair market value of $50,000, and who has COD income of $100,000, can sell the asset during the year of discharge and claim a $50,000 loss. If he sold the asset the following year, his basis would be reduced to zero and he would have $50,000 taxable gain. This time-sensitive tax benefit is specifically provided by the language of the statute. The statutes provide no basis for

treating the taxpayer with suspended losses any differently.[10]

The Taxpayers' position as to the proper treatment of shareholder suspended losses is consistent with § 108's treatment of a "C" corporation's NOLs. In the case of a "C" corporation, the excess of business deductions over business income creates a net operating loss deduction under § 172, which can be carried back to prior years and/or forward to subsequent taxable years, and used as a deduction to reduce taxable income in those years. But, because the current year's NOL is the amount that current year deductions exceed income, the NOL does not affect income and tax liability for the current year. Thus, its reduction by the amount of COD income, when required under the attribute reduction provisions of

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[10] The Taxpayers' interpretation of the statutes would preserve attribute reduction for shareholder losses whenever the losses exceed COD income. TMB:34-35. The Commissioner argues that this position means that the debt discharge amount first passes through to the shareholder for purposes of determining his allowable loss for the taxable year of the discharge, then "magically reappears" at the corporate level to eliminate the remaining loss. CMB:30 n.20. The magic is in the statute: § 108(d)(7)(B) requires, first, that *shareholder* loss in excess of basis, if any, be determined. If there is an excess, the subsection also provides it is to be treated as a corporate NOL subject to reduction at the corporate level under § 108(b)(2)(A). Nor does the Taxpayers' interpretation of the statutes lead to an "absurd result," as the Commissioner maintains. CMB:30 n.20. All losses in excess of the amount of COD income are eliminated, and the greater the shareholder's suspended loss in relation to the amount of debt discharge, the greater the loss subject to reduction.

§ 108(b)(2)(A), will never affect tax liability for the year of the discharge.[11]

Likewise, COD income does not reduce the amount of shareholder suspended losses which can be utilized *in the current year* (as opposed to future years). The attribute reduction required under § 108(b) only operates to reduce shareholder losses that survive the current year, and which, but for § 108, would be carried forward to subsequent years.

F. Section 1366(b) is not in conflict with the Taxpayers' position.

The Commissioner argues that, since excluded COD income is "captured and applied at the corporate level," it cannot be considered a passthrough item under § 1366(a) because to do so would conflict with the "character" rule of § 1366(b). CMB:31. The answer to this argument is that COD income is not "captured and applied at the corporate level" to the extent that §§ 108(d)(7)(B), 1366(a)(1)(A), and 1367(a) require that it be taken into account at the shareholder level. Further, § 1366(b) treats the item in the hands of a shareholder as if the shareholder, and not the S corporation, realized the

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[11] Since attribute reduction occurs after the determination of tax for the year of the discharge, an NOL carryforward *to* the year of the discharge can be used as a deduction during that year. SHEINFELD, MYRON M., FRED T. WITT, JR. & MILTON B. HYMAN, 15 COLLIER ON BANKRUPTCY TAXATION, ¶6.03[4][b][i] (Matthew Bender. 1999). This is consistent with Taxpayers' position that they can use their 1990 suspended losses in computing the 1991 "loss disallowed under § 1366(d)(1)."

item. For example, if an item of income is "long term capital gain" to the corporation, it is to the shareholder as well, irrespective of the fact that the shareholder held his S corporation stock for less than one year. Likewise, § 1366(b) permits a solvent shareholder to take excluded COD of the corporation into account (retaining its exempt character), even though the exclusion was conditioned upon the corporation's insolvency.[12]

II. SUMMARY AND CONCLUSION

The statutory mandate that all items of income be taken into account in computing shareholder basis, provided they could affect shareholder tax liability, could hardly be more clear – all means all. In an effort to avoid this unequivocal mandate, the Commissioner finds that he cannot embrace the rationale of any court's decision where he has previously prevailed. The Commissioner therefore retreats to a non-statutory rule that has been obsolete for 20 years, and urges an interpretation of § 108(d)(7)(B) that would deprive the Taxpayers of the benefits afforded all other insolvent taxpayers, who are

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[12] For similar reasons, the *Farley* court held that the Commissioner's argument that § 1366(b) supports his position is "flawed," stating:

> Section 1366(b) deals with the character of income which has been passed through to the shareholder, while § 108(d)(7)(A) deals with the application of indebtedness exclusion requirement and tax attribution scheme detailed in §§ 108(a) through 108(b). These two statutory provisions address different issues at different levels.

Farley, 202 F.3d at 209.

permitted full use of their losses and other tax attributes in the year of discharge.

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Respectfully submitted,

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